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## HELPING NONPROFITS POLICE THEMSELVES: WHAT TRUST LAW CAN TEACH US ABOUT CONFLICTS OF INTEREST

MELANIE B. LESLIE<sup>1</sup>

### INTRODUCTION

Over the past decade, scandals involving nonprofit boards and conflicts of interest have been the subject of considerable public attention. The resulting bad publicity, Congressional hearings, and calls for reform have failed to mitigate the problem. In 2009 alone the country witnessed several spectacular examples of self-dealing by nonprofit directors. For example, The Boston Globe recently reported that Suffolk University has a \$10,000 per month contract with Wolfblock Public Strategies, lobbyist Robert Crowe's firm. Robert Crowe is also a Suffolk University trustee, and a member of the compensation committee that made University President David Sargent the highest-paid University President in 2006. When two Boston Globe reporters questioned Crowe about the apparent conflict-of-interest, he replied, "[t]o even insinuate there is a conflict is wrong. There is no conflict . . . [w]hether or not my public strategy group is paid \$10,000 is not relevant. We don't make money on that. We are providing a service to Suffolk."<sup>2</sup>

Ezra Merkin, the chair of Yeshiva University's investment committee, invested millions of dollars of Yeshiva University's endowment with Ascot Partners, a hedge fund he controlled.<sup>3</sup> His 1.5% management fee was arguably higher than Yeshiva could have obtained from an arms-length transaction. Worse, Yeshiva's board allegedly did not require Merkin to disclose his investment strategy as a condition to taking the money. The

1. Professor of Law, Benjamin N. Cardozo School of Law. I would like to thank Dana Brakeman Reiser, Evelyn Brody, Ray Madoff, Harvey Dale and Stewart E. Sterk for helpful comments and criticism. Special thanks to my wonderful research assistants, Scott Danner and Eytan Goldschein.

2. Frank Phillips & Peter Schworm, *Trustees' fiscal ties roil Suffolk Conflict-of-interest policy scrutinized*, BOSTON GLOBE, Nov. 26, 2008, at B1. According to Crowe, his firm's annual \$120,000 rate is "half what other lobbying companies would charge." Yet Suffolk University failed to disclose the Wolfblock contract—and several other contracts between Suffolk Trustees and the University—to the Massachusetts attorney general's office, in violation of Massachusetts law. *Id.*

3. Jason Zweig, *The Intelligent Investor: Where Ezra Merkin Lost His Way*, WALL ST. J., Jan. 10, 2009, at B1.

New York State Attorney General alleges that Merkin then quietly entrusted the funds to Bernard Madoff.<sup>4</sup>

In April of 2009, a local newspaper reported that Hackensack University Medical Center's board routinely engaged in major transactions with board members, often without the advance approval of the full board. In response to the newspaper article, the hospital hired two major law firms to "review its governance policies."<sup>5</sup>

The point of this article is not to argue that most board members are bad actors intent on abusing their fiduciary positions for private gain. In fact, directors who sanction problematic conflict-of-interest transactions are often acting in good faith.<sup>6</sup> They believe that transactions with board members are in the nonprofit's best interests, even when they are not, and—like Robert Crowe—often fail to perceive the conflict entirely.

Yet scandals like those cited above damage the credibility of the nonprofit sector. They create the false impression that most nonprofit boards routinely siphon corporate assets away from mission and into board members' pockets. They lead to public calls for greater government regulation of the industry in the form of increased reporting requirements and mandated governance structures. Scholars have argued persuasively that in-

4. David Segal & Alison Leigh Cowan, *Madoffs Shared Much; Question is How Much*, N.Y. TIMES, Jan. 15, 2009, at A1.

5. Mary Jo Layton, *Firms Hired to Review Hospital's Policies; Hackensack's Move in Wake of Influence Peddling Conviction*, THE RECORD (Bergen County, N.J.), April 30, 2009, at L3; Mary Jo Layton, *Hospital's Influence Reaches Far; Tangled Web of Power*, THE RECORD (Bergen County, N.J.), April 26, 2009, at A1. The Hospital's transactions with board members included: the hospital's payment of \$475,000 to a board member for construction services; the hospital's payment of more than \$2 million to Progenitor Cell Therapy, a private stem cell research company owned in part by a board members and the hospital's chief operating officer; the hospital's payment of \$2.5 million to lease space from a company owned and managed by a board member's cousin; and the hospital's payment of more than \$1 million in fees to a law firm in which a board member was a partner. *Id.*

6. In a 2007 study conducted by the Urban Institute's Center on Nonprofits and Philanthropy, more than twenty percent of nonprofits surveyed reported engaging in financial transactions with board members in the preceding two years, and that many of those deals are *not* below market. FRANCINE OSTROWER, NONPROFIT GOVERNANCE IN THE UNITED STATES: FINDINGS ON PERFORMANCE AND ACCOUNTABILITY FROM THE FIRST NATIONAL REPRESENTATIVE STUDY, THE URBAN INSTITUTE, CENTER ON NONPROFITS AND PHILANTHROPY 8–9 (2007). The bigger the charity, the more likely it was to have engaged in a transaction with a board member: among those nonprofits with at least \$10 million in annual expenses, forty-one percent reported transacting with board members in the past two years. Of course, if all of these conflicted transactions were for goods and services at well below market rates, then self-dealing would not result in diversion of nonprofit assets and there would be no reason for concern. But seventy-four percent of charities that admit to engaging in conflicted transactions state that they engage in transactions at "market value," while only fifty-one percent also reported that they obtained some goods and services at below market costs. Oddly, charity size is correlated to the frequency of self-dealing at-market transactions, but not in the direction one might expect: fifty-eight percent of the smallest nonprofits (those with operating expenses less than \$100,000 per year) report that they received goods and services at below market prices, but eighty-five percent of charities with more than \$40 million in annual expenses reported engaging in conflicted transactions for market value, while only twenty-four percent of these charities also reported engaging in below-market deals.

creased regulatory demands would create untenable costs for nonprofits, especially smaller ones, and would be of questionable effectiveness.<sup>7</sup> Yet unless the scandals stop breaking, it seems unlikely that the drive toward increased regulation will abate.

This article argues that there is a better way to reduce the amount of damaging self-dealing in the nonprofit sector: reform the law addressing self-dealing and conflicts of interest to enable nonprofits to do a better job of policing themselves. Much of the blame for these reoccurring scandals rests squarely with the law. Both state fiduciary duty law and the self-dealing provisions of the federal tax code employ fuzzy standards that give little guidance to boards who might be considering transacting with a board member. The law specifies no procedure for ensuring that such transactions advance the nonprofit's best interests, nor does it clearly delineate between acceptable and unacceptable insider transactions. The standards employed allow well-meaning board members to minimize the seriousness of conflicted transactions and facilitate damaging "groupthink." The fact that state and federal laws express these standards using radically different terminology sends an unduly complicated and confusing message to board members.

The problem lies in the reflexive transplantation of corporate law principles to the nonprofit context. Because fiduciary duty law seeks to

7. Some charities may lack the internal capacity necessary to meet additional regulatory demand. Julie Goldscheid establishes that three-quarters of all nonprofits have budgets under \$500,000, and only four percent of nonprofits have budgets that are over \$10 million dollars per year. Many have staffs that lack expertise in accounting, technology and human resources, and many lack sufficient technology to support additional record-keeping demands. Julie Goldscheid, *Supporting Accountability: Assessing the Costs of Regulation*, 9 N.Y. CITY L. REV. 321, 323, 325-327 (2006). As Goldscheid notes, there is a public perception that nonprofits are acting irresponsibly or worse when they dedicate resources to administration instead of to mission. *Id.* at 324-27 (discussing her role, as former General Counsel for Safe Horizons, in coordinating the New York response to the September 11, 2001, disaster, and in particular how the nonprofit sector's lack of infrastructure hampered the ability to quickly distributed funds in comparison to the resources possessed by the for-profit sector). In addition, smaller nonprofits tend to receive a greater proportion of their assets from restricted corporate and foundation grants that cannot be applied towards administrative support. *Id.* at 323.

Those nonprofits that are able to comply may find themselves at a disadvantage in the market for donor dollars, because the costs of compliance increases resources devoted to overhead and away from mission (the severity of this problem correlates with the size of the nonprofit—the smaller the budget, the greater the percentage of charitable assets applied to administration). Professor Dana Brakeman Reiser therefore argues that a rational nonprofit fiduciary might determine that the costs of compliance outweigh the prospect of enforcement. Dana Brakeman Reiser, *There Ought To Be A Law: The Disclosure Focus of Recent Legislative Proposals for Nonprofit Reform*, 80 CHI.-KENT. L. REV. 559, 585-86 (2005). In addition, she points out that many of the new proposed regulations duplicate already existing requirements, which have not had much impact on board behavior. *Id.* at 583-584. See also Goldschieid, *supra* note 7, at 321 ("[R]egulations no doubt are essential in ensuring that nonprofits meet their missions and provide appropriate oversight, accountability, and transparency. However, some of the proposed regulations would impose additional obligations without substantially advancing those goals.").



align the incentives of principal and agent, fiduciary duty law must be context-specific. But there are critical differences between for-profit and nonprofit corporations that make corporate law a very poor tool for minimizing agency costs in the nonprofit sector.

The most obvious difference between for-profit and nonprofit corporations is that nonprofits lack a principal with the financial incentive and legal ability to sue to enforce fiduciary duties. For various reasons, state attorneys general and the Internal Revenue Service rarely bring enforcement actions. There are few market forces that exert pressure on nonprofit fiduciaries to minimize agency costs. Thus, nonprofit boards are generally left to police themselves. Moreover, those boards are less equipped to perform the policing function. Nonprofit directors are generally over-committed volunteers with limited time to devote to governance issues. When nonprofit corporations function effectively—as a great many of them do—it is because the directors, or the most influential among them, have internalized fiduciary duties as social norms.

Thus, the law governing conflicted transactions in the nonprofit context should compensate for the lack of monitoring and board members' lack of time to devote to governing. It should seek to implement (where absent) and support (where existing) the social norm of subordination of self-interest in favor of the nonprofit's best interests (also known as "the non-distribution constraint"). The law's expressive function should be harnessed to clearly direct boards about how to handle conflicted transactions.

Here, there is much to be learned from trust law. Trust law bars transactions between a trustee and the trust unless the trustee, after full disclosure, obtains advance approval of the trust beneficiaries or a court. This clear rule compensates for beneficiaries' poor monitoring abilities and for the lack of market pressures that align trustees' and beneficiaries' interests. The rule, phrased as a prohibition with a procedural safe harbor, also bolsters social norms against self-dealing. When fiduciaries function as a group, the rule has the added benefit of countering the pervasive problem of "groupthink," which occurs when fiduciaries' cognitive limitations combine with a desire for approval of other group members to blind fiduciaries to conflicts and the dangers they present.

Yet policy makers have largely ignored the lessons of trust law, and continue to adopt corporate law standards, most recently in the newest Revision of the Model Nonprofit Code. The reflexive adoption of corporate

law ignores critical differences between the for-profit and nonprofit sectors and has thus created a largely ineffective body of law.<sup>8</sup>

State and federal law should be rewritten to give clear guidance to nonprofits about how to handle relationships with board members. State and federal law addressing conflicted transactions should be harmonized to employ the same rules and terminology, and the law governing conflicted transactions should take the form of clear rules instead of standards. Taking a page from trust law, those rules should *require* board members to approve transactions with board members in advance. And because there is no one with an adverse financial interest in a position to approve the transaction (in contrast to the trust context), the board should be required to substantiate that the transaction is a better deal than what could be obtained on the market. To give this requirement the element of "ruleness," we might pick an arbitrary target: perhaps twenty percent below market value. Clear rules threatening legal liability for failure to determine in advance that a conflicted transaction is in the nonprofit's best interest would reinforce social norms against self-dealing.

## I. FIDUCIARY DUTY LAW MUST BE CONTEXT-SPECIFIC

### A. *Corporate vs. Trust Law*

The objective of fiduciary duty law is to minimize the agency costs that occur when the interests of the agent and principal diverge.<sup>9</sup> For this reason, fiduciary duty law should be context-specific: the substance of

8. There has been some progress on the tax front; the intermediate sanctions "rebuttable presumption" standard is a welcome move toward "ruleness," and anecdotal evidence suggests that it has influenced board behavior. The recently revised form 990, which requires nonprofits to explicitly list all transactions with board members, sends a message to boards that these transactions must be justified. These moves, though helpful, are inadequate to deal with the problems that conflicts of interest present.

9. Frank H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 90-93 (1991); Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J. L. & ECON. 425, 426-27 (1993). Jensen and Meckling explained how fiduciary relationships present the potential for agency costs:

If both parties to the [agency] relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal. The *principal* can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent. In addition in some situations it will pay the *agent* to expend resources (bonding costs) to guarantee that he will not take certain actions which would harm the principal or to ensure that the principal will become compensated if he does take such actions. However, it is generally impossible for the principal or the agent at zero cost to ensure that the agent will make optimal decisions from the principal's viewpoint.

Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976). See also EASTERBROOK & FISCHEL, *supra* note 9, at 8-11; 91-93; Easterbrook & Fischel, *Contract and Fiduciary Duty*, *supra* note 9, at 426; Melvin Aron Eisneberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1471, n.46 (1989).

fiduciary duty law depends upon the objectives of the fiduciary relationship, and the degree to which other forces, such as markets and social norms, help align the incentives of principal and fiduciary.

In trust law, fiduciaries are held to a high standard. For centuries, trust law has stubbornly insisted that when a trustee profits from engaging in a conflicted transaction with the trust, the beneficiary may void the transaction unless the trustee obtained prior approval after full disclosure.<sup>10</sup> The trustee is held *per se* liable simply upon a beneficiary's showing that the trustee had a personal interest in the transaction (the "no further inquiry" rule), even if the self-interested transaction caused the trust no damage.<sup>11</sup> The trustee must disgorge all profits realized as a result of the transaction and return them to the trust.

Consider an example: X is the trustee of a testamentary trust. X is also an accountant. X, as trustee, hires his own accounting firm to prepare tax returns and other tax-related documents on behalf of the trust. He fails to ask the trust beneficiaries or a court for permission to do so. He charges the trust his usual hourly fee each time he performs the work. If the trust's beneficiaries then discover that the trustee has hired himself, they have two options. If the beneficiaries believe that the deal is a good one for the trust, they can "ratify" the transaction by allowing the relationship to continue unfettered. If they believe that the arrangement does not advance their interests, they can sue the trustee for breach of the duty of loyalty. If they sue, they will not be required to prove damages; they will prevail simply by establishing that the trustee was on both sides of the transaction.<sup>12</sup> That the trustee may have charged fees that were commensurate with "fair market value" is not a defense to his breach of duty.<sup>13</sup> The court has discretion to

10. See RESTATEMENT (THIRD) OF TRUSTS § 78 cmt. a (2007) ("[The d]uty of loyalty is, for trustees, particularly strict even by comparison to the standards of other fiduciary relationships.").

11. See RESTATEMENT (THIRD) OF TRUSTS § 78 cmt. b (2007) ("[Under the no further inquiry rule] it is immaterial that the trustee may be able to show that the action in question was taken in good faith, that the terms of the transaction were fair, and that no profit resulted to the trustee.").

12. See *id.* ("[T]he trustee commits a breach of trust by purchasing trust property, even as the highest bidder at a public auction."). The previous Restatement suggests that a trustee should obtain court approval for the purchase of trust property, and that a court should grant that approval only when the purchase is in the beneficiary's best interests:

Purchase by trustee with approval of court. The trustee can properly purchase trust property for himself with the approval of the court. The court will permit a trustee to purchase trust property only if in its opinion such purchase is for the best interest of the beneficiary. Ordinarily the court will not permit a trustee to purchase trust property if there are other available purchasers willing to pay the same price that the trustee is willing to pay.

RESTATEMENT (SECOND) OF TRUSTS § 170 cmt. f (1959).

13. See, e.g., *Marshall v. Carson*, 38 N.J. Eq. 250 (N.J. 1884) (finding that trustee who purchased land from the trust breached duty of loyalty because "there is an inherent conflict of interest in the idea that a purchaser wants to pay the lowest possible price for land, while a trustee wants to sell the land for the best possible price"); *Staats v. Bergen*, 17 N.J. Eq. 554, 559 (N.J. 1867) (finding trustee liable for

impose a wide variety of sanctions, such as removing the trustee or requiring him to disgorge fees to the trust.

Why does the law punish the trustee for failing to obtain advance approval for self-dealing? It does so to compensate for the beneficiaries' difficulties in monitoring the trustee's performance,<sup>14</sup> their inability to diversify or exit,<sup>15</sup> and the absence of market pressures that might induce the trustee to put the beneficiaries' interests first.<sup>16</sup> The trust rule forces *ex-ante* disclosure of conflicts, requires the trustee to justify his proposal, and sends the trustee the strong message that self-dealing is legitimate only when the proposed transaction is superior to alternatives available in the marketplace.<sup>17</sup> The rule works to protect beneficiaries who have no sufficient means of protecting themselves.

In taking this approach, trust law's advance approval requirement supports trust settlors' objectives. A trustee's promise to subordinate its interests to those of the beneficiaries reassures the settlor that her loved ones will be well cared for after her death.

In contrast, corporate fiduciary duty law is more relaxed. Conflicted transactions that are "fair" are not voidable or the basis for finding breach of fiduciary duty, even if the transaction was not first approved by disinterested board members (although prior approval after full disclosure by a

breach of the duty of loyalty for purchasing trust property at a foreclosure sale because "the interest of the [trustee] was directly antagonistic to that of the complainant. A low price was the gain of the defendant, but it was, in the same ratio, a loss to the complainant").

14. Beneficiaries are in a poor position to monitor the trustee's behavior. Often, the reason the beneficiary received the gift in trust, as opposed to outright with no strings attached, is because the settlor had doubts about the beneficiary's financial sophistication. Beneficiaries who are minors, incapacitated, or who lack financial sophistication will be unable to determine whether a trustee is behaving opportunistically. Because of this imbalance of capacity and information, beneficiaries are likely to place substantial trust in the trustee. The trustee's advertised reputation of trustworthiness encourages beneficiaries' reliance on its judgment. Or, if the trustee is an individual, chosen by the settlor for her honesty, competence and knowledge of family relationships, the beneficiary trusts that the trustee will continue to act consistently with past behavior. In either case, the beneficiary is predisposed to believe that the trustee acts at all times in the beneficiaries' best interests. Melanie B. Leslie, *Trusting Trustees: Fiduciary Duties and the Limits of Default Rules*, 94 GEO. L.J. 67, 84 (2005).

15. Sitkoff notes that aftermarkets for beneficiaries' interests are weak; moreover, in many trusts, spendthrift clauses prevent beneficiaries from alienating their interest even involuntarily. Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621, 675-76 (2004).

16. Almost none of the market forces that pressure corporate fiduciaries to forgo opportunistic behavior are at play in the trust context. There is no "share price" or secondary information market that informs other potential customers of a trust term that reduces fiduciary duties or communicates trustees' opportunistic behavior to potential customers. Even if a particular beneficiary discovers that her trustee is performing poorly, she will be unlikely to communicate this to the trustee's other clients, of whom she is unaware. See Leslie, *Trusting Trustees*, *supra* note 14, at 82.

17. As two commentators have noted, "[t]o overcome difficulties in proof, the law infers disloyalty from its appearance, presuming that a fiduciary will appropriate the principal's asset when it is in her self-interest to do so." Robert Cooter and Bradley J. Friedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1055 (1991).



majority of disinterested board members creates a presumption that the transaction was a "fair" one). Prominent corporate scholars justify corporate law's more lenient approach by noting that shareholders are more risk-preferring than trust beneficiaries are. A rule making transactions more costly might make corporate fiduciaries more risk-averse. In addition, these scholars assert that higher thresholds for liability are unlikely to lead to breaches of fiduciary duties because market forces pressure corporate directors to take decisionmaking seriously and to avoid conflicts that are not in the corporation's best interests.<sup>18</sup> The threat of a takeover of corporate control, the need to succeed in product markets, and the job market provide additional incentives for managers to perform in shareholders' best interests. A well-developed information market helps shareholders monitor management's performance: if shareholders learn of managements' opportunistic behavior they will exit, causing stock prices to fall,<sup>19</sup> and reputational damage may result. Moreover, damage from breach of fiduciary duty will be less drastic in the corporate context, because shareholders have the ability to diversify against risk and to exit.

### *B. The Nonprofit Corporation: No Monitors, No Markets*

The central dilemma for nonprofit law is that nonprofit fiduciaries are not accountable to a principal.<sup>20</sup> Although state and federal governments

18. Corporate scholars argue that the market creates significant pressures that minimize agency costs regardless of whether management is bound by fiduciary duties. Managers' compensation might be linked to performance. The threat of a takeover of corporate control, the need to succeed in product markets, and the job market provide additional incentives for managers to perform in shareholders' best interests. Moreover, a well developed information market helps shareholders monitor management's performance. If shareholders learn of managements' opportunistic behavior they will exit, causing stock prices to fall. Thus, although market forces may be inadequate to curb one-shot breaches of the "take the money and run" sort, for the most part fiduciaries will tend to minimize agency costs even if the corporate charter does not require them to do so. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *ECONOMIC STRUCTURE*, *supra* note 9, at 91-92.

As James J. Fishman states:

Perhaps the most important constraint on directors of business corporations is market regulation. The securities, consumer, and occupational markets serve to place deterrents on directors' and management's behavior. Thus, if a director has been remiss, or management has performed poorly, the market price for the corporation's securities will drop as investors move onto other companies. The corporation may have difficulty raising capital. Job prospects and compensation of senior management will be adversely affected. Thus market constraints act to externally enforce fiduciary limits.

James J. Fishman, *Standards of Conduct for Directors of Nonprofit Corporations*, 7 PACE L. REV. 389, 408 (1987).

19. EASTERBROOK AND FISCHEL, *ECONOMIC STRUCTURE*, *supra* note 9, at 96-97.

20. See Susan N. Gary, *Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law*, 21 U. HAW. L. REV. 593, 616 (1999) ("Any person served by the entity has an interest in seeing that it is run properly, but no one person is likely to have the incentive, the ability, or the information necessary to monitor the charity. Further, beneficiaries are unlikely to have standing to enforce their rights as beneficiaries."); See also Evelyn Brody, *Agents Without Principals: The Economic*



have authority to monitor conflicted transactions, enforcement efforts range from minimal to nonexistent.<sup>21</sup> There are a few reasons for this, not all of them bad. Government agencies have limited resources, and may not wish to spend those resources targeting well-intentioned volunteer board members. An announcement that a nonprofit is the target of an investigation can immediately cripple the nonprofit by drying up the flow of donations and grants. If the nonprofit is providing community benefits, a government agency could take the view that reforming corporate practices under the radar would be benefit the community more than crippling the nonprofit would.<sup>22</sup>

The nonprofit corporation is also free from the market pressures faced by its for-profit counterparts.<sup>23</sup> The only significant market pressure that a charity may face—though it can be quite significant—comes from the need to attract capital.<sup>24</sup> Donors and government agencies may require various

*Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. SCH. L. REV. 457, 465 (1996).

21. State attorneys general, representing the public, are the principal monitors of nonprofits, and in most states, the pressure they bring to bear is minimal. Only a small minority of states has charitable enforcement bureaus; for those Attorneys General, charitable monitoring competes for resources with all the other things the AG must do. In the states that do have separate bureaus, funding is limited. When determining how to apply limited resources, attorneys generals face competing demands. Reiser, *supra* note 7, at 598–99 (2005); Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 IND. L. J. 937, 939, 947, 951 (2004); Gary, *supra* note 20, at 623 (1999) (noting that even in those states where the Attorney General's office has an active enforcement division, most enforcement efforts occur in response to complaints by whistleblowers or the press).

22. Often, an attorney general would prefer to do something other than pursue litigation against a legitimate charity. When the questionable activity appears to fall short of a major breach of duty, attorneys general often work with the charity to reform it rather than resort to litigation. See Brody, *Whose Public?*, *supra* note 21, at 948; James J. Fishman, *Improving Charitable Accountability*, 62 MD. L. REV. 218, 268 (2003).

23. Melanie B. Leslie, *The Wisdom of Crowds? Groupthink and Nonprofit Governance*, 52 FLA. L. REV. (forthcoming Dec. 2010). The market for donations creates some pressure, sometimes significant. Sources of capital include donations from members of the public, corporate and foundation grants, and government support. In a few settings the market for grants may discipline not-for-profit fiduciaries. Competition for corporate and private foundation grants is significant, and these entities often require significant financial disclosure as a condition for repeat giving. These funders often pay close attention to the charity's effectiveness in accomplishing its mission. In New York City, for example, there are scores of small charities that receive almost all of their funding from the city government. The greater the percentage of government and large foundation grants, the more effective the monitoring. The Urban Institute's Study shows that the level of a nonprofit's reliance on government funding is positively associated with having an outside audit, a separate audit committee, a conflict-of-interest policy, and a whistleblower policy. OSTROWER, *supra* note 6, at 6.

24. Leslie, *supra* note 23. Sources of capital include donations from members of the public, corporate and foundation grants, and government support. In a few settings the market for grants may discipline not-for-profit fiduciaries. Competition for corporate and private foundation grants is significant, and these entities often require significant financial disclosure as a condition for repeat giving. These funders often pay close attention to the charity's effectiveness in accomplishing its mission. In New York City, for example, there are scores of small charities that receive almost all of their funding from the city government. The greater the percentage of government and large foundation grants, the more effective the monitoring. The Urban Institute's Study shows that the level of a nonprofit's reliance

degrees of disclosure or accountability as a condition for repeat giving, which may exert some pressure on the nonprofit to refrain from self-dealing that does not advance the charities' best interests. But funders do not have standing to sue for breach of fiduciary duty.<sup>25</sup> Moreover, because most charities rely on a diverse array of sources for funding, the pressure is insufficient to discipline boards who are predisposed to contract with board members. Thus, it is up to boards of directors to police themselves — to effectuate the intentions of charitable donors by ensuring that charitable assets go towards the charity's mission and not into the pockets of insiders.

Finally, there is no need to encourage risk-taking by allowing self-dealing in the nonprofit sector. The non-distribution constraint is the essential feature of the nonprofit; it is the board's implicit promise not to self-deal that creates the incentive to give by promising donors that donations will be applied—directly or indirectly—towards the charity's mission.<sup>26</sup> Those who donate to nonprofits may, of course, support other types of risk-taking, such as innovative programming, but those types of risk do not necessarily require transactions with board members. Thus, we can assume that donors would want to authorize transactions with board members only when those transactions clearly advance the nonprofit's charitable objectives.

## II. CORPORATE LAW STANDARDS FAIL TO MINIMIZE AGENCY COSTS IN THE NONPROFIT SECTOR

As currently structured, the law is an ineffective mechanism for deterring harmful conflicted transactions. When nonprofit corporations function effectively—and a great many of them do—it is because the most vocal directors have internalized fiduciary duties, such as the non-distribution constraint, as social norms. For example, Ezra Merkin, the Yeshiva University trustee, was also a member of the investment committee of the UJA Federation. But the UJA Federation's board had adopted two rules that stopped it from investing endowment funds with Merkin. First, the organization's Ethical Guidelines and Practices prohibited directors from manag-

on government funding is positively associated with having an outside audit, a separate audit committee, a conflict-of-interest policy, and a whistleblower policy. OSTROWER, *supra* note 6, at 6.

25. See Gary, *supra* note 20, at 616. In a revolutionary move, the recently drafted Uniform Trust Code purports to grant standing to settlors of charitable trusts. UNIF. TRUST CODE § 409 (2005), available at <http://www.law.upenn.edu/bll/archives/ulc/uta/2005final.pdf> (last visited Mar. 2, 2010). It is unclear whether this provision will have much impact on nonprofit governance, since most donors fail to make donations in charitable trust form.

26. See Henry Hansmann, *The Role of the Nonprofit Enterprise*, 89 YALE L.J. 835, 877, 896 (1980).

ing the organization's funds.<sup>27</sup> Second, the investment committee would not engage any financial services professional without first conducting due diligence, including obtaining an understanding of the professional's investment strategy.<sup>28</sup> No law required the Federation to adopt these policies.

The essence of the fiduciary arrangement is the fiduciary's promise to subordinate self-interest in favor of the nonprofit's best interests. When fiduciaries have internalized this promise as a social norm, they engage in informed decisionmaking and refrain from approving questionable conflicted transactions because "it is the right thing to do."<sup>29</sup> But when dominant directors have not internalized those norms, neither law nor markets play a meaningful role in preventing self-interested behavior.

As currently structured, state fiduciary duty law does nothing to plant or support fiduciary norms in environments where fiduciaries have failed to internalize them. Most states have adopted the fiduciary duty of loyalty standards applicable to for-profit corporations.<sup>30</sup> Recent scandals such as those at Enron, WorldCom, and Tyco cast doubt on the effectiveness of corporate fiduciary duty standards to align the interests of board members and corporations even in the for-profit context. Most state law provides that conflicted transactions are not void, or the basis for imposing personal liability, if they are "fair" to the corporation. The board can obtain the presumption of fairness if it obtains the approval of a majority of the disinterested board members in advance, after full disclosure.

The Internal Revenue Code, which also polices conflicted transactions, is equally ineffective in minimizing self-dealing. The Code, like

27. The UJA Federation's Ethical Guidelines and Practices provide that "No member of the Investment Committee shall manage, participate in any manager selected to manage, or have a material ownership interest in an UJA-Federation fund." Ethical Guidelines and Practices of United Jewish Appeal-Federation of Jewish Philanthropies of New York, Inc. § C.1, <http://www.ujafedny.org/assets/documents/PDF/bottom-nav/Policies/ETHICAL-GUIDELINES-11.1.09-CURRENT-Website.pdf> (November 2009).

28. Asher Meir, *Charities, Financial Institutions and the Public Trust*, Dec. 18, 2008, <http://www.besr.org/Article.aspx?ArticleID=590> (Dec. 18, 2008).

29. Melvin Eisenberg draws on the work of Robert Cooter and economist Kaushik Basu to posit that fiduciary duties are more than simply legal rules. Eisenberg, *supra* note 9, at 1258-1263. They are "obligational norms"; that is, norms of behavior that are sufficiently ingrained in the culture that violation of the norm will incite self-censure or the judgment of others. *Id.* at 1257. Eisenberg argues that many obligational norms are internalized. *Id.* at 1257-58. Internalized norms comprise an aspect of individual character, and individuals will honor it reflexively, even if doing so causes them to forgo material gain. *Id.* at 1258-60.

30. The 1988 version of the Revised Model Nonprofit Corporation Act provides that a conflict of interest transaction is not void or the basis for imposing liability if it is either (a) fair to the corporation, or (b) was approved by a majority of the disinterested directors, or a committee of the board, after full disclosure, and the voting board members "in good faith reasonably believed" that the transaction was fair. REVISED MODEL NONPROFIT CORP. ACT § 8.31 (1988) (adopted in full or in part by twenty-three states).

many state laws on the subject, is comprised of fuzzy standards that do little to plant or support fiduciary duties as social norms.<sup>31</sup> Moreover, the Code exacerbates the “fuzziness” problem by adopting terminology different than that used in state law. Although Treasury regulations provide that nonprofits can obtain a rebuttable presumption of reasonableness if the transaction is approved in advance,<sup>32</sup> at the culmination of a thorough decisionmaking process, this safe harbor provision is not part of the blackletter law, and thus undermines its expressive force.

Fuzzy standards fail to correct directors’ cognitive limitations, such as confirmation bias and an inflated view of their own fairness and objectivity.<sup>33</sup> Cognitive limitations facilitate destructive “groupthink,” which can

31. The Internal Revenue Code contains three different doctrines addressing board transactions with interested directors, articulated in terms equally as fuzzy as state law. First, the code directs that the charities must abstain from conferring more than an incidental private benefit on individuals other than insiders. I.R.C. § 501(c)(3) (2006); Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (2009). The code also prevents insiders from obtaining private inurement. See I.R.C. § 501(c)(3) (2006); Treas. Reg. § 1.501(c)(3)-1(c)(2) (2009). Finally, the IRS may sanction insiders who receive an “excess benefit” from transacting with the board and managers who approve the excess benefit transaction. I.R.C. § 4958-1(b)-(c)(1) (2006) (imposing penalties on “disqualified persons” who engage in “excess benefit” transactions, and the managers who approve them, and defining “excess benefit transaction” as “any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit”).

32. Under treasury regulations, advance approval by a committee confers the presumption that the transaction does not confer an excess benefit on an insider, provided that the committee is made up entirely of independent directors. Treas. Reg. § 53.4958-6(a)(1)-(3) (2009).

33. Individuals have cognitive limitations that can impede rational and efficient decision making, such as deficits in memory and computation skills, limits on the amount of information they can process, or overestimating their own judgment or abilities. Individual cognitive limitations can also facilitate groupthink. For example, when faced with complicated issues, people exhibit “confirmation bias.” See generally Raymond S. Nickerson, *Confirmation Bias: A Ubiquitous Phenomenon in Many Guises*, 2 REV. GEN. PSYCHOL. 175 (1998). People will seek out information that confirms their beliefs, interpret neutral information as confirming their beliefs, and will fail to seek out and ignore information that challenges their instincts. See James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 L. & CONTEMP. PROBS. 83, 88-91 (1985) (discussing extensive behavioral research studies supporting this point); see also Charles G. Lord, et al., *Biased Assimilation and Attitude Polarization: The Effects of Prior Theories on Subsequently Considered Evidence*, 37 PERSONALITY & SOC. PSYCHOL. 2098, 2099-2102 (1979) (establishing that people tend to interpret ambiguous information to confirm their initial point of view); Antony Page, *Unconscious Bias and the Limits of Director Independence*, 2009 U. ILL. L. REV. 237, 265 (2009). Most people also overestimate their own objectivity and ability to be fair. Most individuals view themselves as more fair and moral than other people, and this self-conception causes them unconsciously to favor interpretations of reality that confirm that view. See Dolly Chugh et al., *Bounded Ethicality as a Psychological Barrier to Recognizing Conflicts of Interest*, in CONFLICTS OF INTEREST: CHALLENGES AND SOLUTIONS IN BUSINESS, LAW, MEDICINE AND PUBLIC POLICY 75, 84 (Don A. Moore, et al., eds. 2005). That is, in addition to “bounded rationality,” group members suffer from “bounded ethicality”: a limited ability to recognize ethical challenges inherent in a decision involving a conflict of interest. *Id.* at 75. See generally, Leslie, *supra* note 23.



undermine social norms that facilitate good governance procedures.<sup>34</sup> Groupthink occurs when the desire to win the approval of other group members—and the fear of social sanction that may attach for challenging the group's point of view<sup>35</sup>—cause directors to place allegiance to fellow board members ahead of the nonprofit's best interests.<sup>36</sup> Groupthink blinds directors to conflicts of interest, and may also induce directors to refrain from adequately monitoring ongoing business relationships with board members.<sup>37</sup> The phenomenon can create defects in the group decisionmaking process that have been shown to lead to poor decisionmaking: the group members may fail to express dissent;<sup>38</sup> ask questions or consider the full range of alternative options;<sup>39</sup> decline to re-examine the decision initially preferred by a majority of group members in light of changing events; make little effort to obtain information by asking questions or consulting experts or outsiders with information;<sup>40</sup> and exhibit bias in their reactions to information, focusing on facts or opinions that confirm the group's initial inclination and ignoring those that do not.<sup>41</sup> Finally, groupthink may lead members to spend too little time exploring how their course of action might later be derailed by opponents, accidents or future occurrences.<sup>42</sup>

34. Irving L. Janis appears to have first coined the term in his book, *VICTIMS OF GROUPTHINK* (1967). As he explained: "I use the term 'groupthink' as a quick and easy way to refer to a mode of thinking that people engage in when they are deeply involved in a cohesive in-group, when members' strivings for unanimity override their motivation to realistically appraise alternative courses of action." *Id.* at 9.

35. Irving Janis explains the studies:

Whenever a [group] member says something that sounds out of line with the group's norms, the other members first increase their communication with the deviant. Attempts to influence the nonconformist member to revise or tone down his dissident ideas continue as long as most members of the group feel hopeful about talking him into changing his mind. But if they fail after repeated attempts, the amount of communication they direct toward the deviant decreases markedly. The members begin to exclude him, often quite subtly at first and later more obviously, in order to restore the unity of the group. . . . [Experiments show that] the more cohesive the group and the more relevant the issue to the goals of the group, the greater is the inclination of the members to reject a nonconformist. Just as the members insulate themselves from outside critics who threaten to disrupt the unity and esprit de corps of their group, they take steps, often without being aware of it, to counteract the disruptive influence of inside critics who are attacking the group's norms.

*Id.* at 5.

36. *Id.* at 8–9; CASS R. SUNSTEIN, *GOING TO EXTREMES* (2009).

37. See Cox & Munsinger, *supra* note 33, at 105–108.

38. See Samuel N. Fraidin, *Duty of Care Jurisprudence: Comparing Judicial Intuition and Social Psychology Research*, 38 U.C. DAVIS L. REV. 1, 50–58 (2004) (considering a number of psychological studies that establish that group decisions are better when group members express dissent).

39. Studies show that groups that consider multiple alternatives have a greater chance of arriving at a decision that represents the best course of action. *Id.* at 42–46.

40. JANIS, *supra* note 34, at 12; Fraidin, *supra* note 38, at 42–46.

41. JANIS, *supra* note 34, at 10. Janis explains that each of these defects may be caused by other factors, such as fatigue, prejudice, stupidity or ignorance. *Id.* at 10–11.

42. *Id.* at 10.



Nonprofit boards are uniquely vulnerable to groupthink,<sup>43</sup> because information asymmetries are more pronounced,<sup>44</sup> market pressures are relatively weak, and board members may view themselves less as monitors and more as fundraisers and "supporters" of the group's executive director.<sup>45</sup> In some cases, board members may view membership as conferring an entitlement to self-deal, especially when board membership comes at a price. As Deborah DeMott explains,

[D]irectors' motives and incentives for service on nonprofit boards differ dramatically from motives and incentives in the for-profit environment. . . . Board members often join because they believe in an organization's mission and contribute to it with financial donations. They depend heavily on organization management to set the board's agenda and provide information to the board. Many large nonprofits also have relatively large boards. Some actors in this environment reportedly believe that directors who make financial contributions have a reciprocal entitlement to self-deal. Indeed the prospect of self-dealing may entice some directors to serve and to make financial contributions to the organization.<sup>46</sup>

Instructing nonprofit boards that transactions with board members are fine if they are "fair," or "not excessive" enables board members to convince themselves that most transactions fit this standard.<sup>47</sup> The fiduciary

43. See generally Leslie, *supra* note 23.

44. Evelyn Brody writes that "Nonprofit directors devote even less time and attention to their positions. Such affirmative board duties as selecting the chief officer, preparing the budget, and reviewing operations are likely to be carried out haphazardly or by only a few of the board members." Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400, 1445-1446 (1998). David Barrett stresses that, "unlike for-profits, the board of many nonprofits consists of uncompensated volunteers. These volunteer directors are usually very busy people who hold other full-time jobs and simply do not have as much time to devote to their duties as most inside directors of for-profits." David W. Barrett, *A Call for More Lenient Director Liability Standards for Small, Charitable Nonprofit Corporations*, 71 IND. L.J. 967, 967 (1996).

45. See Leslie, *supra* note 23. The Urban Institute's Recent Study indicates that boards that focus board recruiting efforts on friends and acquaintances of current board members did less well with every aspect of governing except fundraising, where it had no impact. FRANCINE OSTROWER, NONPROFIT GOVERNANCE IN THE UNITED STATES: FINDINGS ON PERFORMANCE AND ACCOUNTABILITY FROM THE FIRST NATIONAL REPRESENTATIVE STUDY 16 (2007). The more diverse a board, the less vulnerable it is to groupthink. Perhaps this is why the percentage of ethnic and minority group members is positively associated with having an outside audit, a separate audit committee, a conflict of interest policy and a whistle blower policy. *Id.* at 6. The percentage of female board members positively correlates with having conflict of interest and whistleblower policies. *Id.* at 5.

46. Deborah A. DeMott, *Self-Dealing Transactions in Nonprofit Corporations*, 59 BROOK. L. REV. 131, 140-41 (1993).

47. In group experiments, this unconscious bias often causes group members to judge an act that gives an advantage to one group member as "fair" even when it is not. See Chugh et al., *supra* note 33, at 86-88. This tendency blinds group members to the ethical issues implicit in decisions involving a conflict of interest. In these situations, group members either tend to believe that the conflict will not affect their judgment, *id.* at 82, or they entirely fail to perceive the conflict at all. Page, *supra* note 33, at 259. In fact, instead of appreciating the ethical and legal issues presented by a conflict of interest transaction, group members often view the transaction as an opportunity to reward particular group members for loyalty to the group. Some group members may even feel obliged to confer such rewards. Chugh et al., *supra* note 33, at 76.

norm is supplanted by an allegiance to the group, with the result that board members are more likely to authorize transactions that actually siphon assets away from mission and into director's pockets.

### III. THE JUSTIFICATIONS ADVANCED FOR APPLYING CORPORATE LAW STANDARDS TO NONPROFIT ORGANIZATIONS ARE UNPERSUASIVE.

From time to time in the past few decades, scholars have argued that conflicted transactions by nonprofit boards should be reviewed under a standard that is stricter than corporate law provides.<sup>48</sup> Yet these thoughtful arguments have been ignored by those who craft uniform statutes. The following sections examine some frequently-invoked justifications for adopting corporate law, and argue that those justifications lack force.

#### *A. Trust Law is Moving Toward Corporate Law.*

Some argue, in defense of the status quo, that trust law's duty of loyalty has lost its vigor, and thus is a poor model for the nonprofit rules.<sup>49</sup> Indeed, the past two decades have seen banks engage in vigorous and successful lobbying efforts to water down the duty of loyalty. The slow erosion of the Glass-Steagall Act, which culminated in its repeal in 1999,<sup>50</sup> induced increasing numbers of institutional trust companies to merge, affiliate with or purchase financial institutions offering investment banking services.<sup>51</sup> As a result, increasing numbers of institutions are entering the trust market, and increasing numbers of institutional trustees are in a position to obtain additional financial benefits by investing trust assets in related companies. When this happens, the corporation benefits twice, earning both trustee commissions and other fees, such as those related to the management and sale of the investment.

48. See DeMott, *supra* note 46, at 143 (proposing that self-dealing transactions be voidable unless the transaction's proponents can affirmatively establish its fairness to the corporation at the time of the transaction); Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems and Proposed Reforms*, 23 IOWA J. CORP. L. 631, 650-51 (1998) (arguing that courts should not apply the business judgment rule when reviewing a board's decision to approve a self-interested transaction, but should review the transaction for fairness); Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 569 (1981) (advocating a ban on self-dealing in the nonprofit context).

49. See ALI Principles of the Law of Nonprofit Organizations, Tentative Draft No. 1 (March 19, 2007), page 1 (justifying the rejection of trust law as a model for nonprofit rules in part because "recent years have brought a liberalization of the trust rules").

50. 12 U.S.C.A. § 377 (1935), *repealed by* Pub. L. No. 106-102, § 1, 113 Stat. 1341 (1999).

51. See Joan M. LeGraw & Stacey L. Davidson, *Glass-Steagall and the "Subtle Hazards" of Judicial Activism*, 24 NEW ENG. L. REV. 225, 226-28 (1989).

Banks now view their trust departments as profit centers, and have sought legislative concessions that allow them to maximize profits by engaging in activities that would violate the centuries-old duty of loyalty. State legislatures have responded to these lobbying efforts by enacting statutes that allow banks to engage in particular types of conflicted transactions without threat of liability. To the extent that these statutes represent an erosion of the trust prohibition against self-dealing without advance approval, they are unjustifiable, and grounded not on sound policy considerations but on the commercial interests of banks.

*B. Nonprofits Function Like For-Profit Corporations.*

In justifying the adoption of corporate rules, some emphasize that nonprofit corporations bear closer structural and functional similarities to for-profit corporations than they do to trusts.<sup>52</sup> Trustees, they argue, simply manage assets. Nonprofit boards run businesses.<sup>53</sup> Moreover, because many nonprofit directors are often business executives, for-profit and nonprofit rules should be streamlined to avoid confusion.

But focusing on superficial resemblances misses the point. The project should be to identify and construct rules that will minimize agency costs in a particular context. The key factors are the roles that markets, law and social norms play in aligning principal and agent incentives, and the extent to which the law must compensate for the absence of other monitoring forces.

The argument in favor of aligning nonprofit and for-profit standards to avoid confusion for board members who operate in both worlds has some force in the cases of the largest nonprofits, where board members are likely to serve on multiple boards of both nonprofits and for-profits. But streamlining is more important when the law is comprised of fuzzy standards that require study and the advice of counsel to interpret. If nonprofit rules are simple and clear, the fact that they are different than for-profit rules can be easily communicated to sophisticated board members.

52. As one court put it, "[T]he modern trend is to apply corporate rather than trust principles in determining the liability of the directors of charitable corporations, because their functions are virtually indistinguishable from those of their 'pure' corporate counterparts." *Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses*, 381 F. Supp. 1003, 1013 (D.D.C. 1974).

53. See ALI Principles of the Law of Nonprofit Organizations, Tentative Draft No. 1 (March 19, 2007), page 3 (arguing that "many charities today operate enterprises to the management demands of a complex business, making corporate fiduciary standards appropriate") (on file with author).

### *C. The Trust Law Duty of Loyalty is Only a Default Law*

Another argument offered for rejecting the trust law approach characterizes the “advance approval” rule as an artifact that parties avoid by simply drafting out if it.<sup>54</sup> Thus, the reasoning follows, the advance approval requirement is a dead rule, rarely invoked by courts. It makes no sense to extend a moribund rule—one that trust settlors themselves avoid—to the nonprofit context.<sup>55</sup>

But in fact, settlors rarely, if ever, waive the duty of loyalty protections by providing that corporate law will govern trustee’s self-dealing transactions. Instead, waivers are transaction-specific—that is, settlors typically authorize the trustee to engage in particular transactions that would otherwise constitute a breach of the duty of loyalty. When a settlor authorizes a particular conflict-of-interest in advance, she does so with full information and with the knowledge that authorizing the conflict will best advance her purposes in creating the trust. For example, she may place shares of a family-owned business in trust, appoint her son, the CEO of the company, as trustee, and authorize the trustee to buy and sell the trust’s shares. This waiver of the duty of loyalty allows her necessary flexibility in managing the family business. Because the trust is funded with the settlor’s money, and because she has full information about the terms of her trust, trust law allows this exception to the duty of loyalty. The advance approval requirement comes into play later, after the settlor relinquishes control to the trustee and entrusts the trustee with the beneficiaries’ interests. The rule does its work to ensure that her wishes are carried out. Thus, the fact that settlors can authorize specific conflicted transactions is not evidence that the advance approval rule is dead or undesirable.

### *D. Trust Law is “Too Restrictive” Because Nonprofits Need to be Able to Engage in Below-Market Transactions with Directors.*

The primary justification for rejecting trust law’s advance approval rule is that it would bar transactions that compensate for the nonprofit’s

54. See Evelyn Brody, *Charity Governance: What’s Trust Law Got To Do With It?*, 80 CHI.-KENT. L. REV. 641, 658 (2005) (“[T]he settlor of a charitable trust typically includes provisions in the instrument that relieve the trustee(s) of legal duties to the maximum extent permitted; this generally results in a lenient standard like that imposed on corporate directors.”).

55. See ALI Principles of the Law of Nonprofit Organizations, ALI Principles of the Law of Nonprofit Organizations, Tentative Draft No. 1 (March 19, 2007), page 1 (explaining the reporter’s decision to adopt corporate law instead of trust law standards as justified because “well counseled” settlors often relax the duty of loyalty in the trust document).



ability to raise capital.<sup>56</sup> Nonprofits aggressively set out to recruit potential board members who can offer goods and services for discounted prices, and therefore help the nonprofit devote more resources to mission and less to overhead.<sup>57</sup> Trust law, the argument goes, would damage the nonprofit by prohibiting these types of transactions,<sup>58</sup> or increasing the transaction costs associated with entering them.

First, this argument misunderstands trust law. As explained previously, trust law has never completely prohibited self-dealing. Rather, it has prohibited self-dealing without advance approval, by the beneficiaries or a court, after full disclosure. The rule simply compensates for lack of monitoring by forcing early disclosure of conflicts and requiring the fiduciary to justify its decision to self-deal in advance.

Second, the argument that market value conflicted transactions are beneficial because they save transaction costs is a nonstarter. The transaction costs saved—pricing the market, finding the best deal for the nonprofit, sanctioning the deal in advance—are the very costs that we want the board to incur. Eliminating these costs is what leads a board to engage—sometimes quite innocently and with the best of intentions—in deals that waste money or, worse, lead to egregious acts of self-dealing. Groupthink often blinds directors to the real costs of these transactions, and discourages them from doing the leg work that might reveal that the transactions are not quite the good deals that they may at first appear to be.

### *E. Rules That Have Teeth Deter Board Service*

An argument that is regularly made against imposing any rules that seem to lower the threshold for liability for board members is that competent people will simply decline to serve on nonprofit boards if they fear they might inadvertently do something that will expose them to embarrassment and liability. I do not wish to minimize the seriousness of the problem of attracting competent board members. But if board members could easily access and understand the rules, giving them a clear sense of

56. See Evelyn Brody, *Institutional Dissonance in the Nonprofit Sector*, 41 VILL. L. REV. 433, 500 (1996) (“[P]eople often make desirable directors because of their ties to certain businesses and their ability to obtain certain goods or services for the nonprofit on terms favorable to the nonprofit. Barring such insider transactions would cost the nonprofit sector dearly.”); see also, Susan N. Gary, *Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law*, 21 U. HAW. L. REV. 593, 635 (1999) (arguing that “[o]btaining help from directors may enable some nonprofits, in particular small, local nonprofits, to survive. An absolute prohibition on such transactions seems too drastic.”).

57. See OSTROWER, *supra* note 6, at 7.

58. See ALI Principles of the Law of Nonprofit Organizations, Tentative Draft 1 (March 19, 2007), page 53 (stating that “under trust law, transactions... between the trustee and the trust traditionally have been forbidden”).



what behavior exposes them to liability, the threat of legal exposure might be less of a hindrance than it currently is.

#### IV. CONCLUSION

A law tailored to minimize self-dealing in the nonprofit context would compensate for the current lack of monitoring by forcing disclosure of conflicts, would ensure prospective donors that their donations would be dedicated to the nonprofit's mission and not to the personal benefit of board members, would be simple and easy to understand to ensure that volunteer and overcommitted board members access it, and would be procedurally oriented, to reassure board members that if they follow the rules they will be invulnerable to personal liability. Trust law's advance approval requirement would do a better job of facilitating those objectives than corporate law currently does.

Of course, trust law is not a perfect fit; the advance approval rule works because it requires the acquiescence of trust beneficiaries, who have a direct financial interest in the trust, to give approval. The nonprofit corporation lacks a monitor who will be affected financially by a conflicted transaction. This distinction justifies a flat prohibition on nonprofit transactions with board members. But because this suggestion is politically untenable, I offer an alternative proposal. Prior to engaging in a transaction with a board member, the transaction must be approved by the Attorney General or a majority of all disinterested directors. Because these particular directors do not have a direct financial interest in the transaction, there should be a requirement that the directors establish (and document) that the transaction is superior to one that could be obtained through a market place transaction. To give this requirement the character of "ruleness," it might make sense to impose an arbitrary bright line rule, such as requiring that the board establish that the transaction is twenty percent lower than prevailing market rates.

If the board fails to follow the advance approval procedure, then a court could impose any penalties or reforms that it finds advisable, including imposing personal liability on board members who participated in or authorized a self-dealing transaction without board approval. The threat of liability, however remote, for failing to follow the required procedure would help compensate for the lack of enforcement efforts by government actors. This clear directive, backed up by the threat of a sanction, would go far to support and reinforce social norms against self-dealing.